

memorandum

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Br4:RBWeinstock

date: AUG 25 1989

to: District Counsel, Des Moines
Attn: Christopher J. Faiferlick

from: Assistant Chief Counsel (Tax Litigation)

subject: [REDACTED] v. Commissioner, T.C. Docket No. [REDACTED]
[REDACTED] v. Commissioner, T.C. Dkt. No. [REDACTED].

This memorandum is in response for your request for tax litigation advice in these cases.

ISSUE

Whether an I.R.C. § 501(c)(5) organization realizes any unrelated business taxable income because of the free distribution of publications to its members by the organization's taxable subsidiary.

CONCLUSION

We believe that the Service will have a very difficult time in convincing the Tax Court that the publishing activities of the taxable organization should be attributed to the exempt organization. We recommend that you settle these cases on the most favorable terms that you can obtain.

BACKGROUND

[REDACTED] is an agricultural organization which promotes the development of the [REDACTED] producing industries and is described in I.R.C. § 501(c)(5). In [REDACTED], [REDACTED] organized a taxable subsidiary, [REDACTED] to carry out [REDACTED]'s business activities, including the publication of [REDACTED]'s official magazine, [REDACTED]. [REDACTED]'s members are county or multi-county organizations of [REDACTED], and the members of such organizations who participate in a state market deduction program. Each member pays at least \$[REDACTED] annually to the county or multi-county organization.

Prior to entering into the contractual arrangement with [REDACTED], [REDACTED]'s magazine was published by an unrelated corporation under a contract that in return for publishing the [REDACTED], the unrelated corporation would receive all of the advertising income generated by the [REDACTED]. Under the

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contract, [REDACTED] furnishes a list of recipients and the corporation sent the magazine free of charge. [REDACTED] had certain rights to review the editorial content. Dissatisfaction with the production of [REDACTED] resulted in cancelling the contract with the corporation, and entering into a similar agreement with [REDACTED].

[REDACTED] has one employee who handled advertising sales, the editing, and publishing activities for the magazine from her home. [REDACTED] performs certain services for [REDACTED], including billing and collection of advertising, sale of inventory items and the sale of [REDACTED] at the state fair. [REDACTED] made payments to [REDACTED] of \$[REDACTED] in [REDACTED], \$[REDACTED] in [REDACTED], and \$[REDACTED] in [REDACTED] for the services [REDACTED] performed for [REDACTED]. [REDACTED] pays another organization to maintain its mailing list, and the [REDACTED] is mailed by the printer to [REDACTED]'s members. [REDACTED] paid a fee to [REDACTED] for maintaining [REDACTED]'s mailing list for all purposes. Most of the readership content of [REDACTED] was written mostly by [REDACTED] one employee, and by several freelance writers that [REDACTED] retained on an independent contractor basis. [REDACTED] staff did write committee reports, a one page comment page published under an officers' name, and schedules of [REDACTED] activities.

In the statutory notice issued to [REDACTED], the Service took the position that the transfer of the right to sell advertising in the [REDACTED], [REDACTED]'s trade publication, at no cost obligated the Organization to report unrelated business taxable income based on the value of the non-advertising readership content. The amounts attributed to readership content costs were treated as a constructive dividend to [REDACTED] in a statutory dividend issued to [REDACTED]. This is not a case where a portion of the advertising receipts were distributed to the exempt organization. It is our understanding that the Service is attempting to settle this case on a slightly different position resulting in a lower tax by allocating membership receipts against readership costs. However, the entire amount of the advertising income continues to be attributed to [REDACTED].

ANALYSIS

I.R.C. § 511(a)(1) imposes a tax on the unrelated business taxable income (UBTI) (as defined in I.R.C. § 512) of organizations described in I.R.C. § 501(c). I.R.C. § 512(a)(1) defines the term "unrelated taxable income" to mean the gross income derived by an organization from any unrelated trade or business (as defined in I.R.C. § 513(a)) regularly carried on by it, less the allowable deductions that are directly connected with the carrying on of the trade or business, both computed with the modifications provided in I.R.C. § 512(b).

I.R.C. § 513(a) defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived).

I.R.C. § 513(c) provides with respect to advertising and similar activities the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. An activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may or may not be related to the organization's exempt purposes.

Rev. Rul. 73-424, 1973-2 C.B. 190, held that income derived by a labor organization from the sale of advertising in an annual yearbook constitutes unrelated business taxable income where an independent commercial firm, under a full-time contract with the exempt organization, received a fixed percentage of the gross receipts from selling the advertising, collecting from advertisers and printing the yearbook. Although the publication was distributed on annual basis, the advertising solicitations required a significant span of time and an extensive campaign and were therefore not materially different from similar commercial endeavors. This ruling focused on whether the advertising activity was regularly carried on. The only income which constituted unrelated business taxable income was the organization's share of the advertising receipts.

Treas. Reg § 1.512(a)-1(f)(3)(iii) provides that where the right to receive an exempt organization periodical is associated with membership in such organization for which dues, fees, or other charges are received (hereinafter referred to as "membership receipts"), the circulation income of the periodical includes the portion of such membership receipts allocable to the periodical (hereinafter referred to as "allowable membership receipts"). Allocable membership receipts is the amount which would have been charged and paid if the periodical was that of a taxable organization, and the member was an unrelated party dealing with the taxable organization at arm's length.

If [REDACTED] had published [REDACTED] itself, it would have had to impute a certain portion of its membership receipts in computing its UBTI. Treas. Reg. § 1.512(a)-1(f). The Service apparently viewed the use of [REDACTED] as an attempt to circumvent the regulations, particularly the imputation of membership receipts. However, membership receipts are not taxed, but included in the computation of the amount, if any, of an organization's unrelated business taxable income from advertising. These cases differ

from the facts of Rev. Rul. 73-424, insofar as [REDACTED] does not receive any share of [REDACTED] advertising receipts. 1/

In order for [REDACTED]' activities to be attributed to [REDACTED], it is necessary to disregard [REDACTED] separate corporate existence. Generally, in order to disregard a corporate entity, "there must be a finding that the corporation or transaction involved was a sham or fraud without any valid business purpose, or the finding of a true agency or trust relationship between the entities." National Carbide Corporation v. Commissioner, 336 U.S. 422 (1949). The standards to disregard the corporate entity are rather stringent. Under National Carbide Corporation, more than a mere showing that one entity is owned by another is required to establish that an entity is the agent of the other. Its business purpose must be the carrying out of the normal duties of an agent. It should be noted that the requirement that a subsidiary have a bona fide business purpose does not require that the subsidiary conduct an inherently commercial or for-profit activity.

There are other factors to be considered in determining whether a subsidiary's separate corporate existence should be disregarded. Another factor that is considered is the extent to which an organization is involved in the day to day management and operations of the subsidiary.

Based on the administrative file materials provided to our office, we believe that the organization can establish that it was set up for a legitimate business purpose. From the materials in the administrative file it also would appear that the Service would have a very difficult task to establish that [REDACTED] was so involved in or in control of [REDACTED] day to day operations that [REDACTED] can be treated as [REDACTED]'s agent. While [REDACTED] did own all of [REDACTED] corporate stock, and supplied staffing to [REDACTED], [REDACTED] does have one employee who was not an employee of [REDACTED]. Furthermore, while there were some common directors, the two corporations did not have identical boards of directors. We suspect the Tax Court would not ignore [REDACTED] corporate existence, and would not attribute its activities, income and expenses to [REDACTED]. Accordingly, we recommend that you try to settle this case on the best terms possible.


1/ We note that the alternative position used by St. Louis Appeals is based on a technical advice memorandum in which the exempt organization actually received a portion of the advertising income of a publication. This approach didn't address the fundamental problem of attributing one organization's activities as those of another organization.

CONCLUSION

Based on the administrative file, we believe that the Tax Court will not attribute the activities of [REDACTED] to [REDACTED] and we recommend settlement on the most favorable terms possible. We have coordinated this matter with the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), and this memorandum is in accord with the preliminary views they have expressed to us. We will provide you with a copy of the dated O.M. as soon as we receive it. If you have any other questions, or require our further assistance, please do not hesitate to contact Ronald Weinstock at FTS 566-3345.

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By:


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